Internal Revenue Service

memorandum

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VWATERS

date: OCT 11 1989

to: Regional Counsel, Central Region CC:C

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: Settlement Agreements in Docketed TEFRA Cases

This is in response to your July 7, 1989, request for tax litigation advice regarding the above-referenced subject matter. You raised several concerns and questions which address the Service's position regarding partial settlements in docketed Tax Court cases.

QUESTIONS PRESENTED

1. Whether a partial settlement agreement with respect to a partner in a partnership proceeding under I.R.C. §§ 6221 through 6233 enables the Service to assess the tax attributable to the partnership items despite the restrictions on assessment in section 6225?

2. Whether the assessment of deficiencies attributable to settled partnership issues prior to complete resolution of the entire case is consistent with Tax Court Rule 248?

3. Whether our position should be changed to accommodate the Partnership Control System's inability to control and track multiple statutes of limitations?

4. Whether multiple affected items notices of deficiency for the additions to tax can be issued to a partner in a fractured settlement of a single partnership case?

5. Whether the Service and a partner should include in any partial settlement a stipulation that the partial settlement does not constitute a settlement agreement under section 6231(b)(1)(C)?

6. Whether the period of limitations on assessment begins to run when the settlement agreement is entered into or when the decision of the Tax Court becomes final?

CONCLUSIONS

1. A partial settlement in a partnership proceeding converts the settled items to nonpartnership items under section 6231(b)(1)(C). Consequently, the restrictions on assessment of tax attributable to partnership items under section 6225 do not preclude assessment of the tax attributable to the converted items pursuant to sections 6230(a)(1) and (a)(2)(A)(ii).

2. We do not believe that there exists an inconsistency between Tax Court Rule 248 and our position that a partial settlement triggers the one year period of limitations of section 6229(f). Rule 248 does not apply to partial settlements. Rather, it applies to situations where some or all partners settle their entire cases.

3. The inability of PCS to control and track multiple statutes of limitations is not determinative of whether partial settlements constitute settlements under section 6231(b)(1)(C).

4. The Service may issue multiple affected items notices of deficiency for the additions to tax to a partner in a fractured settlement of a single partnership case pursuant to Temp. Treas. Reg § 301.6231(a)(5)-1T(d).

5. We believe that a stipulation in the partial settlement agreement that the partial settlement does not constitute a settlement agreement under section 6231(b)(1)(C) would have no affect because it is possible that the court could determine that such agreement is a settlement notwithstanding the stipulation since labels are not controlling. Accordingly, because of the litigation hazards, we recommend that the assessment be made within the one year period of limitations of section 6229(f).

6. The period of limitations on assessment begins to run when the Service executes the settlement agreement pursuant to section 6231(b)(1)(C).

BACKGROUND

The Service may enter into a binding settlement agreement as to a partnership item with any partner. See I.R.C. § 6224(c)(1). Section 6229(a) generally provides for a period of limitations for assessment of tax attributable to partnership items as being three years after the later of: (1) the date on which the partnership return was filed; or (2) the last day for filing such return for the year (determined without regard to extensions). Section 6229(f) provides a special rule for items that become nonpartnership items. That section provides as follows:

(f) Items Becoming Nonpartnership Items.--If, before the expiration of the period otherwise provided in this section for assessing any tax imposed by subtitle A with respect to the partnership items of a partner for a partnership taxable year, such items become nonpartnership items by reason of 1 or more of the events described in subsection (b) of section 6231, the period for assessing any tax imposed by subtitle A which is attributable to such items (or any item affected by such items) shall not expire before the date which is 1 year after the date on which the items become nonpartnership items. This period described in the preceding sentence (including any extension period under this sentence) may be extended with respect to any partner by agreement entered into by the Secretary and such partner.

Section 6231(b)(1)(C) provides in pertinent part:

(b) Items Cease To Be Partnership Items In Certain Cases.-

(1) In general.- For purposes of this subchapter, the partnership items of a partner for a partnership taxable year shall become nonpartnership items as of the date-

(C) the Secretary enters into a settlement agreement with the partner with respect to such items.

The Service's position regarding settlement agreements is that a partial settlement agreement, when reduced to writing and executed by the parties, causes a section 6231(b) conversion and starts the section 6229(f) statute. If there are other partnership items remaining, the partner is still part of the partnership proceeding for those items. Accordingly, each partner in a TEFRA partnership could have several section 6229(f) assessment periods. This position applies to both settlement agreements and stipulations of settled issues.

DISCUSSION

I. Whether a partial settlement agreement with respect to a partner in a TEFRA partnership proceeding enables the Service to assess the tax attributable to the partnership items despite the restrictions on assessment of section 6225(a).

I.R.C. § 6225(a) prohibits the assessment or collection of any deficiency attributable to a partnership item until 150 days after the mailing of the notice of final partnership

administrative adjustment ("FPAA") to the tax matters partner ("TMP") or, if a petition is filed in the Tax Court, until the decision of the court becomes final. Any action to assess or collect the tax in violation of the restrictions under section 6225(a) may be enjoined in the proper court. I.R.C. § 6225(b). However, the Service may assess tax against the partner when the partner waives the restrictions placed on the Service's action under the unified partnership procedures. Temp. Treas. Reg. § 301.6224(b)-1T(a).

We do not, however, need to rely on the waiver provision to enable the Service to make an immediate assessment where the partner and the Service have entered into a settlement agreement. Section 6225 only applies to partnership items. As noted above, where the Service enters into a settlement agreement or a partial settlement agreement with a partner, the items to which the settlement relates convert to nonpartnership items and the partner is no longer subject to the TEFRA proceedings. I.R.C. § 6231(b)(1)(C). Generally, the tax treatment of items that become nonpartnership items is determined under the regular audit, deficiency and refund procedures instead of the TEFRA procedures. I.R.C. § 6230(a)(2)(A). The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), however, amended section 6230(a)(2)(A)(ii) to provide that the deficiency procedures do not apply to partnership items which are converted because of a settlement agreement. In light of this amendment to section 6230(a)(2)(A)(ii), statutory notices need not be issued prior to an assessment. The Service is authorized to make a computational adjustment immediately after the settlement agreement is executed.

II. Whether the assessment of deficiencies attributable to settled partnership issues prior to the complete resolution of the entire case is consistent with Rule 248.

There is no inconsistency between T.C. Rule 248 and our position that a partial settlement constitutes a settlement under section 6231(b)(1)(C). The Tax Court adopted T.C. Rule 248 to provide comprehensive procedures applicable to settlement agreements which may affect some or all of the parties to the partnership proceeding. These procedures must be followed once a petition for readjustment of partnership items has been filed in accordance with section 6226.

Under T.C. Rule 248(a), all of the parties to the action will be bound by a stipulation executed by the TMP and filed with the court if the TMP consents to the entry of decision. The signature of the TMP on such stipulation constitutes a certification by the TMP that no party objects to the entry of decision. Parties to the action include the TMP, the partner who filed the petition and each partner who has an interest in the

outcome of the action. T.C. Rule 247(a). Accordingly, all partners are parties except those who have entered into settlement agreements or consistent settlements with the Service and those who are no longer parties because of special enforcement considerations. See I.R.C. § 6231(c).

T.C. Rule 248(b) sets forth the procedure that should be followed where all "participating partners" in a partnership action have settled. The term "participating partner" is defined in T.C. Rule 247(b) as the partner who filed the petition and such other partners who have filed either a notice of election to intervene or a notice of election to participate in accordance with the provisions of T.C. Rule 245. T.C. Rule 248(b) requires the Commissioner to submit to the court a proposed decision document and motion for entry of decision. If any of the nonparticipating partners object to the granting of the Commissioner's motion for entry of decision, then that party must, within 60 days from the date on which the Commissioner's motion was filed with the court, file a motion for leave to file a motion of election to intervene or to participate, as appropriate. T.C. Rule 248(b)(4).

T.C. Rule 248(c) is intended to provide comprehensive procedures applicable to settlement agreements which may affect some or all of the parties to the partnership proceeding. It provides two objectives. First, it provides a mechanism whereby the court and participating partners are notified that a settlement or consistent agreement has been entered into by some but not all participating partners and that such partners are no longer parties to the proceeding. In addition, the Rule affords all partners the opportunity of entering into a consistent settlement based on a settlement agreement entered into by any partner, whether or not a participating partner. See T.C. Rule 248(c)(2).

We do not believe there is an inconsistency between our position and the aforementioned rules because these rules do not apply to partial settlements. A decision under T.C. Rule 248(a) or (b) may be entered into only after the entire case has been settled. That is, a decision under T.C. Rule 248 is not entered in a partially agreed case. Although T.C. Rules 248(a) and (b) are not explicitly limited to complete settlements, it is apparent that they are so limited. T.C. Rules 248(a) and (b) relate to cases where the Tax Court enters a decision pursuant to the parties' stipulation or the respondent's motion. The Tax Court does not enter "partial" decisions. It resolves all issues properly raised in a single decision. Consequently, a partial settlement would not fall within the ambit of T.C. Rule 248(a) or (b).

T.C. Rule 248(c) addresses situations where some but not all partners settle their case. T.C. Rule 248(c) is not limited by its terms to comprehensive settlements. In view of the apparent purposes of T.C. Rule 248(c), however, we nevertheless do not believe that it is necessarily inconsistent with our position regarding assessment following partial settlements. T.C. Rule 248(c)(1) requires the respondent to notify the Tax Court when there is a settlement agreement or consistent settlement with participating partners. The apparent purpose is to keep the court apprised of which parties remain as participants in the proceeding. Notice of partial settlements keeps the court apprised of which issues remain to be determined. Consequently, complying with T.C. Rule 248(c)(1) is not inconsistent with our view that partial settlements should be assessed.

T.C. Rule 248(c)(2) requires the Service to notify the TMP as to the identity of parties to a settlement and the terms of the settlement of each partnership item. In addition, T.C. Rule 248(c)(2) requires the TMP to serve a copy of the notice on all parties to the action. The apparent purpose of requiring the TMP to serve notice on all of the parties to the action is to provide them the opportunity to enter into a consistent settlement based upon a settlement entered into by any partner. Theoretically, T.C. Rule 248(c)(2) could apply to both settlement agreements and partial settlement agreements. However, in order for a partner to be afforded consistent treatment, the settlement must "be comprehensive, that is, a settlement may not be limited to selected items." Temp. Treas. Reg. § 301.6224(c)-3T(b). Since only comprehensive settlements give rise to consistent settlement rights, T.C. Rule 248(c)(2) applies only to comprehensive settlements. Accordingly, T.C. Rule 248(c) is not inconsistent with our position that assessment should follow partial settlements.

III. Whether our position should be changed to accommodate the Partnership Control System's ("PCS") inability to control and track multiple statutes of limitations.

We do not believe that our position that partial settlements convert items covered by the agreement should be changed to accommodate the logistical problems involving PCS. We have adopted this position to protect against expired periods of limitations. There are no court decisions addressing this issue; accordingly, there are serious hazards of litigation that a court will determine that a partial settlement constitutes a settlement under section 6231(b)(1)(C). It would then follow that those items convert to nonpartnership items and become subject to the one year period of limitations in section 6229(f).

We recognize that PCS may need to be restructured to control and track multiple periods of limitations. However, the

inability of PCS to control multiple statutes is irrelevant to the legal question of what constitutes a settlement. It is merely an administrative consideration to be taken into account in determining the ramifications of our position.

IV. Whether multiple affected items notices of deficiency for the additions to tax can be issued to a partner in a fractured settlement of a single partnership case.

After the partnership proceeding is completed and the computational adjustment is being applied, an affected items statutory notice of deficiency asserting additions to tax will be issued to the respective partners. See Temp. Treas. Reg. § 301.6231(a)(6)-1T(a). In general, the affected items statutory notice asserting additions to tax may not be sent until after the conclusion of the partnership level proceeding. See N.C.F. Energy Partners v. Commissioner, 89 T.C. 741 (1987); Maxwell v. Commissioner, 87 T.C. 783 (1986). As noted above, the partnership audit and litigation provisions no longer apply to converted partnership items. Accordingly, the Tax Court decisions of N.C.F. Energy Partners and Maxwell do not preclude the Service from issuing a notice of deficiency determining additional deficiencies attributable to affected items until after the conclusion of the partnership proceeding because the converted partnership items are immediately removed from the TEFRA partnership proceedings.

In addition, you questioned whether in a fractured settlement of a single partnership case multiple affected items notices of deficiency for the additions to the tax can be issued to a partner. A fractured settlement in a single partnership case arises where the Service and the partners enter into more than one partial settlement agreement thereby resulting in multiple periods of limitations for assessment pursuant to section 6229(f). You noted in your request that this situation is neither covered in Temp. Treas. Reg. §§ 301.6231(a)(5)-1T(d) nor 301.6231(e)-2T. We agree that Temp. Treas. Reg. § 301.6231(e)-2T does not address the question of whether the Service may issue multiple notices of deficiency in a fractured settlement. However, we believe that Temp. Treas. Reg. § 301.6231(A)(5)-1T(d) does contemplate multiple affected items statutory notices. If the applicability of a penalty can be established based on settled issues (e.g., the statutory floor for application of an addition to tax has been reached), an affected items statutory notice may be issued. However, if all conditions have not been met, the Service must wait until the conclusion of the TEFRA proceeding to assert the penalty. For example, settled issues may give rise to an underpayment that surpasses the $1,000 statutory floor for application of section 6659, but not be sufficient standing alone to meet the test for substantial understatement in section 6661(b)(1). In that case,

a statutory notice could be issued with respect to section 6659 while the application of section 6661 would have to await the conclusion of the partnership level proceeding. In that case, multiple affected items statutory notices would be permitted. See also I.R.C. § 6230(a)(2)(C).

Accordingly, the Service is not precluded from issuing to a partner multiple affected items notices of deficiency for the additions to tax.

V. Whether the Service and a partner should include in any partial settlement a stipulation that the partial settlement does not constitute a settlement agreement under section 6231(b)(1)(C).

We believe that there are litigation hazards involved where the Service and a partner stipulate in a partial settlement agreement that the partial settlement does not constitute a settlement agreement under section 6231(b)(1)(C). There are litigation hazards because the court could determine that the partial settlement is in fact a settlement under section 6231(b)(1)(C) irrespective of what the stipulation provides since it is well established that labels are not controlling. For example, in Frank Lyon Co. v. United States, 435 U.S. 561 (1978), property had been transferred in a sale-leaseback transaction. In concluding that the taxpayer-lessee was entitled to the depreciation deductions the Court looked to whose capital was being exhausted and not to the form of the transaction. Specifically, the Court stated "[i]n the field of taxation, administrators of the laws and the courts are concerned with the substance and realities, and formal written documents are not rigidly binding." Accord Helvering v. Lazarus & Co, 308 U.S. 252 (1939). As such, the Service would still be required to make the assessment within the one year period of limitations of section 6229(f).

Although not raised in your request, a similar argument can be made as to whether the Service and a partner can agree that the partial settlement is not effective until the decision becomes final. Similarly, there are serious litigation hazards involved with taking this approach, and our office recommends against this type of agreement.

VI. Whether the period of limitations on assessment begins to run when the settlement agreement is entered into or when the decision of the Tax Court becomes final.

As noted above, the Code provides that partnership items of a partner become nonpartnership items as of the date the Service enters into a settlement agreement with the partner. I.R.C.

§ 6231(b)(1)(C). In addition, section 6229(f) provides that the Service must assess any tax attributable to the settlement agreement within one year from the date on which the items become nonpartnership items. Consequently, the period of limitations on assessment begins to run when the settlement agreement is executed by both parties and not when the decision of the Tax Court becomes final.

You noted in your request that our position appears to be inconsistent with section 686.2(4) of the Appeals Division TEFRA Handbook (Draft April 18, 1989) which provides that the period of limitations on assessment begins to run when the decision of the Tax Court becomes final. In addition, you stated that the position taken in the Handbook draft is most consistent with section 6225(a). As discussed above, section 6225(a) does not preclude assessment of the tax attributable to the converted items since that provision is no longer applicable to the converted partnership items. Moreover, section 686.2(4) of the Handbook draft refers to the one year period of limitations under section 6229(d)(2) rather than section 6229(f). Section 6229(d)(2) specifically provides that the one year period does not begin to run until one year after the decision becomes final. That language is not contained in section 6229(f).

If you have any questions regarding this matter, please contact Vada Waters at (FTS) 566-3289.

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